



OFFICE OF THE
CITY AUDITOR

A REVIEW OF CITY FRANCHISED TOWING

- Of the Nine Franchise Towing Companies Six are Incurring Losses on City Generated Tows
- Insurance Costs
- Franchise Fees
- Lack of Geographic Zone Comparability

A REPORT TO THE
SAN JOSE
CITY COUNCIL

TABLE OF CONTENTS

| | <u>Page</u> |
|----------------------------------------------------------------------------------------------|-------------|
| Executive Summary | i |
| Introduction | 1 |
| Audit Scope | 1 |
| Background | 3 |
| Of the Nine Franchise Towing Companies Six are Incurring Losses on City Generated Tows | 5 |
| Profit or Loss From City Tows (Chart I) | 8 |
| Net Income Per Tow (Chart II) | 9 |
| Abandoned Vehicles/Emergency Tows (Chart III) | 10 |
| Insurance Costs | 12 |
| Insurance Costs - Percentage Increases (Chart IV) | 14 |
| Franchise Fees | 15 |
| Franchise Fee Effect on Company Profits (Chart V) | 16 |
| Lack of Geographic Zone Comparability | 17 |
| Composition of City Generated Tows (Chart VI) | 19 |
| CONCLUSION | 20 |
| RECOMMENDATIONS | 21 |
| ATTACHMENT | |

EXECUTIVE SUMMARY

The City Auditor obtained and reviewed financial statements for the nine franchise towing companies for the most recent fiscal or calendar year. The financial statements for the nine franchise towing companies indicate that as a group they lost approximately \$390,000 on City generated towing business during 1985. Further analysis revealed that while emergency tows were more profitable than abandoned vehicle tows, only three of the nine franchise towing companies made an overall profit on City generated tows.

In addition, according to various franchisee representatives, rapidly escalating insurance costs are a justification for significantly increasing the City established maximum allowable tow charge of \$49.00. Our review of franchisee financial records indicates that in 1985 insurance costs ranged from \$15,695 to \$71,629 and accounted for 3.8 to 14.8 percent of total franchise operating expenses. Discussions with franchise towing companies regarding 1986 insurance costs revealed a range of premium increases on liability insurance from 94 to 192 percent. When all factors are considered, however, increased insurance costs are not sufficient in and of themselves to account for observed or anticipated franchisee losses on City generated tows.

An additional concern voiced by certain franchise towing companies is that the 13 percent Franchise Fee is onerous given the lack of profitability on City generated business. Our analysis revealed that based upon total City generated revenues for the nine franchise towing companies, Franchise Fees would have been \$145,824. As such Franchise Fees would have comprised approximately 9 percent of total City generated towing expenses for the nine franchisees. In no instances did the imposition of the Franchise Fee mean the difference between a franchisee making a profit or incurring a loss on City generated tows. However, the franchisees incurring the largest losses on City generated tows ironically are required to pay the largest Franchise Fees.

Finally, a major problem regarding the issue of City towing is that the nine geographic zones are not homogeneous regarding the volume or type of City generated tows. There is a great deal of disparity between the franchisees as to 1) the total number of City generated tows and 2) the relative mix of emergency and abandoned tows. This disparity makes comparisons between the franchisees obscure. However, based upon our analysis it is readily apparent that abandoned vehicles are a major source of franchisee operating losses.

It is recommended that:

Recommendation #1:

The Administration consider recommending to the City Council that some temporary relief from Franchise Fees be granted to franchise towing companies.

Recommendation #2:

The Administration consider recommending to the City Council that the City pay temporarily a subsidy to franchise towing companies to partially offset the cost of handling abandoned vehicles.

Recommendations #3:

Should Recommendations 1 and 2 be adopted, the Administration should impose on franchise towing companies sufficiently stringent recordkeeping requirements to facilitate subsequent City assessment of the need to continue providing assistance to the franchisees.

Introduction

In accordance with City Charter Section 805(c), the Office of the City Auditor has responded to a City Council request for audit services. On January 14, 1986, the City Council directed the City Auditor to verify franchise towing company assertions regarding 1) the cost of responding to City generated tows and 2) the inadequacy of the City established maximum rate per tow these companies may charge.

Audit Scope

The City Auditor obtained and reviewed financial statements for the nine franchise towing companies for the most recent fiscal or calendar year. For one of the companies the most recent financial statement was for only a six month period while for the other eight companies the statement covered a one year period.

Our review involved gathering financial data and statistics from City records, interviewing franchise towing company owners and personnel, interviewing City personnel, observing franchise towing company facilities and operations and reviewing preliminary findings and conclusions with franchise towing company owners and City personnel.

In addition, we discussed with the franchise towing company owners any unique characteristics or vagaries specific to their operations or geographic tow zones.

We did not conduct a financial audit of the information the franchise towing companies supplied to us. Accordingly, we do not express any opinion on the fairness or accuracy of the financial data presented in this report.

Background

In accordance with City ordinances, the City of San Jose selects one franchise towing company for each of nine geographic districts within the City. The City selects the nine franchisees on a competitive bid basis. Franchise towing companies have the right to all City generated towing business within their geographic zone. City generated tows are of two basic types: San Jose Police Department calls for towing (impounded and emergency) and City calls to tow abandoned vehicles.

In exchange for the right to the above City generated business, franchisees are required to pay a fee to the City. This fee is 13% of City generated towing revenue.

Franchise towing companies must follow specific procedures and processes when 1) responding to City generated tows and 2) subsequently handling and storing the towed vehicles. In the case of abandoned vehicles, the process is as follows:

| <u>Action</u> | <u>Time Lag</u> |
|-----------------------------------------|---------------------|
| Car towed from street to primary lot | |
| Police review and value | after 5 days on lot |
| Removal to secondary storage lot | |
| Lien sale process | 30-90 days |
| End lien sale, disposal to auto wrecker | |

The above process involves time, paperwork and expense for the franchisee over and above that of a normal commercial tow.

When the franchise tow system was initiated, the Franchise Fee was intended to reimburse the City for the costs associated with the program. Tow fees were set at a level that should allow the franchisees to operate profitably under the franchise tow system. Franchise tow companies are now claiming that the franchise tow business is not profitable. They further contend the City's premise that profits from City emergency tows more than offsets losses from abandoned vehicles is no longer valid. According to the franchise towing companies, the major causes of their unprofitable operations are an increase in abandoned cars, increased costs of operation, lack of demand for abandoned vehicles and the resultant decrease in salvage revenues, and a maximum allowable charge tow (\$49) that is too low.

OF THE NINE FRANCHISE TOWING COMPANIES
SIX ARE INCURRING LOSSES ON
CITY GENERATED TOWS

Financial statements for the nine franchise towing companies indicate that as a group they lost approximately \$390,000 on City generated towing business during 1985. Further analysis revealed that while emergency tows were more profitable than abandoned vehicle tows, only three of the nine franchise towing companies made an overall profit on City generated tows. While the lack of entrepreneurial skill or organizational inefficiencies may be causal to some of the observed franchisee losses, it appears that some form of City relief or assistance is needed.

In order to respond to the City Council's request for information regarding franchise towing operations, the City Auditor obtained financial statements and other pertinent data from the nine franchise towing companies. For eight of the companies the City Auditor obtained financial statements covering a twelve month period ending between September 30 and December 31, 1985. For one of the companies a six month financial statement ending on December 31, 1985 was obtained. This was done because the most current available twelve month statement was for the period July 1, 1984 through June 30, 1985. Accordingly, in the interest of using the most recent and relevant financial data available the six month financial statement was used.

Based upon our analysis of the franchise towing companies' financial records, the nine franchisees made 17,642 City generated tows in 1985. Of these 17,642 tows, 10,827 were emergency tows and 6,815 were abandoned vehicle tows. Exhibit A is a summary of the allocation of tows, income, and expenses for City generated tows by franchise towing company.

We estimate that the franchise towing companies lost a combined total of \$389,849 on the 17,642 City generated tows, an average of \$22.10 per tow. Of the nine franchise towing companies:

- o All incurred losses on abandoned vehicle tows
- o Four incurred losses on both emergency and abandoned vehicle tows
- o Two made a profit on emergency tows but incurred a net loss overall on City generated tows
- o Three made a profit on emergency tows and made an overall profit on City generated business

We estimate the profits for the three franchisees that made an overall profit on City generated tows to be \$6,557, \$21,845, and \$6,544. Our estimated losses for the remaining seven franchisees varied from \$6,025 to \$120,137.

Charts I through III* display the following information:

- Chart I - net profit or loss by franchisee for City emergency tows and abandoned vehicle tows.
- Chart II - Net income or loss per tow by franchisee for City emergency tows and abandoned vehicle tows.
- Chart III - Revenue and costs per tow for City emergency tows and abandoned vehicle tows.

As Charts I through III clearly demonstrate all of the franchise towing companies incurred losses on abandoned vehicle tows. Such losses varied from a low of \$15 per tow to a high of \$127 per tow. Conversely, with emergency tows the results varied from a low of a \$36 per tow loss to a profit of \$30 per tow.

*It should be noted that the Operator Numbers displayed on these and other charts in this report do not correspond to City designated towing zones.

CHART I

Profit or Loss from City Tows

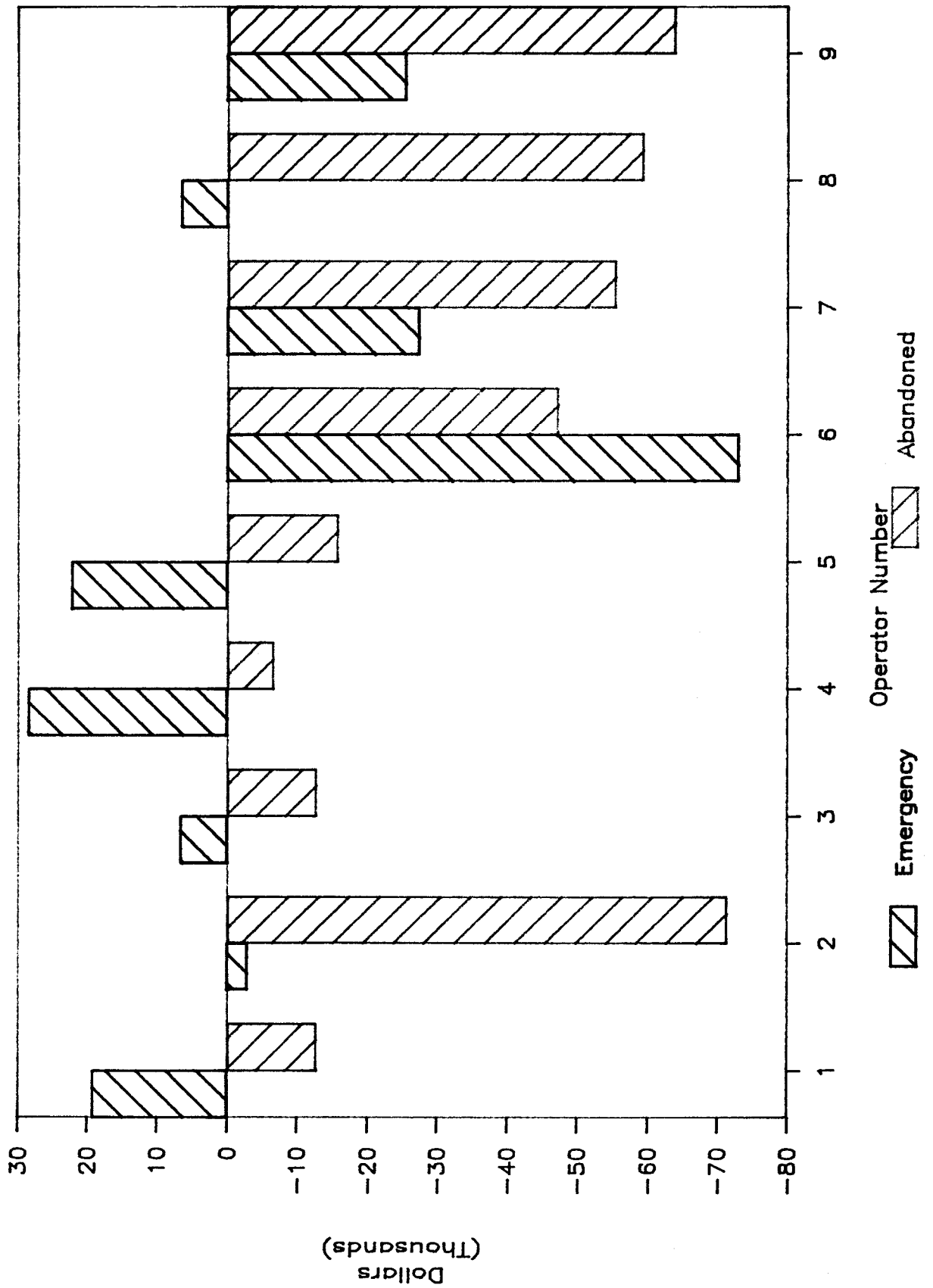
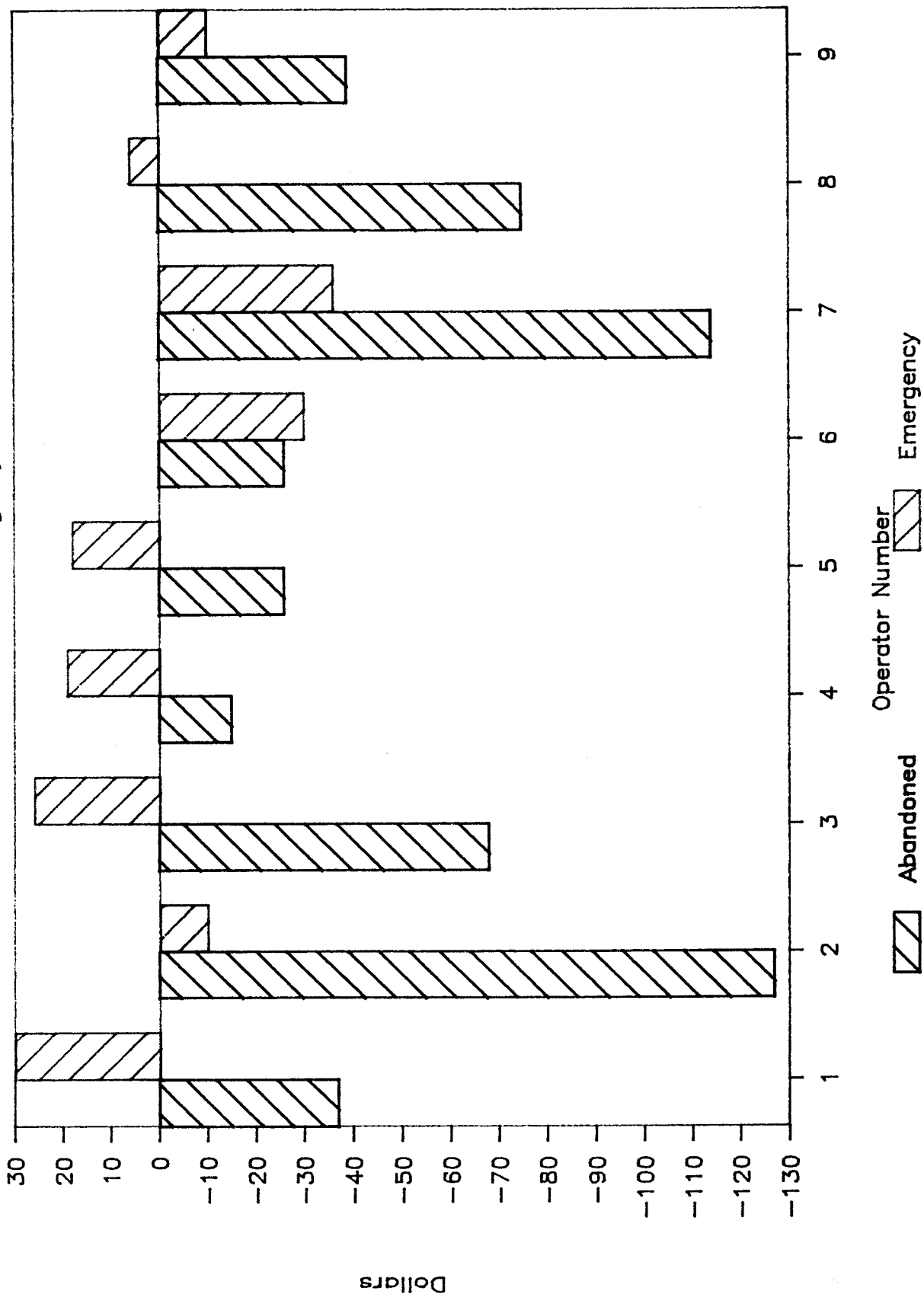


CHART II

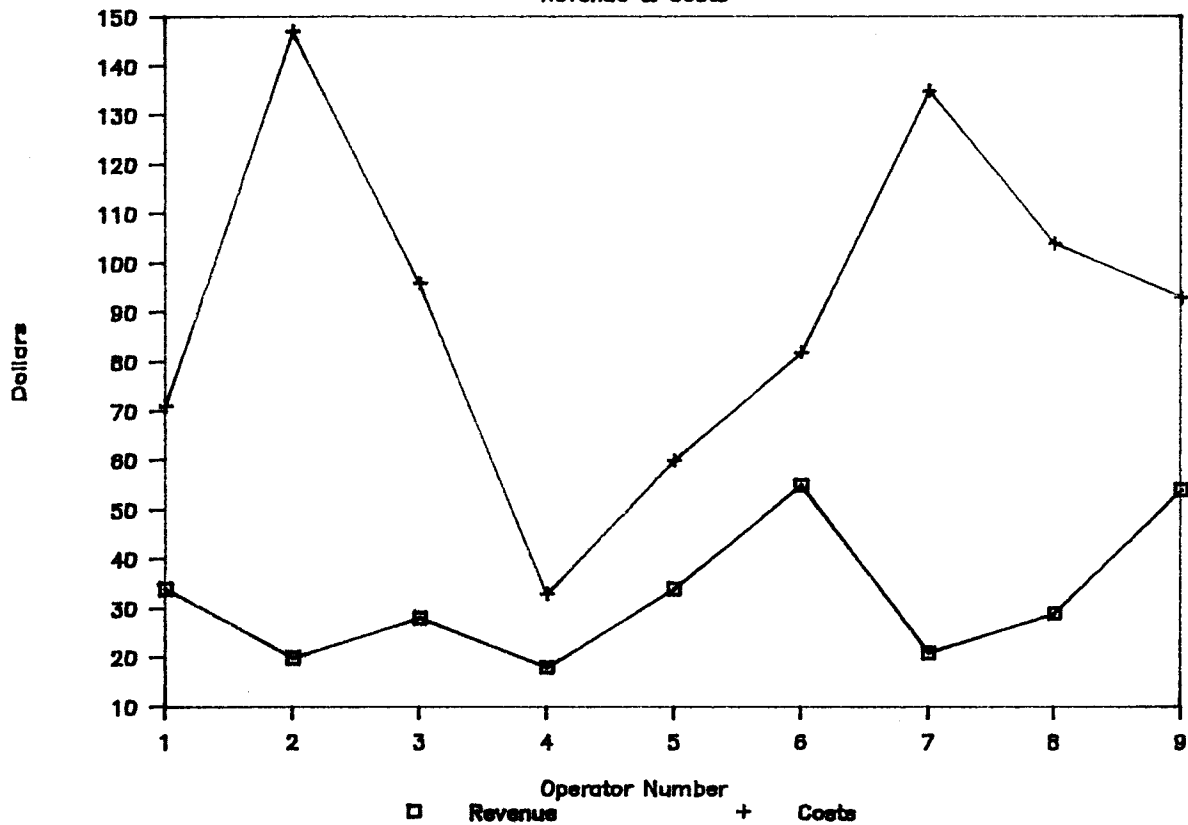
Net Income Per Tow

Abandoned vs. Emergency



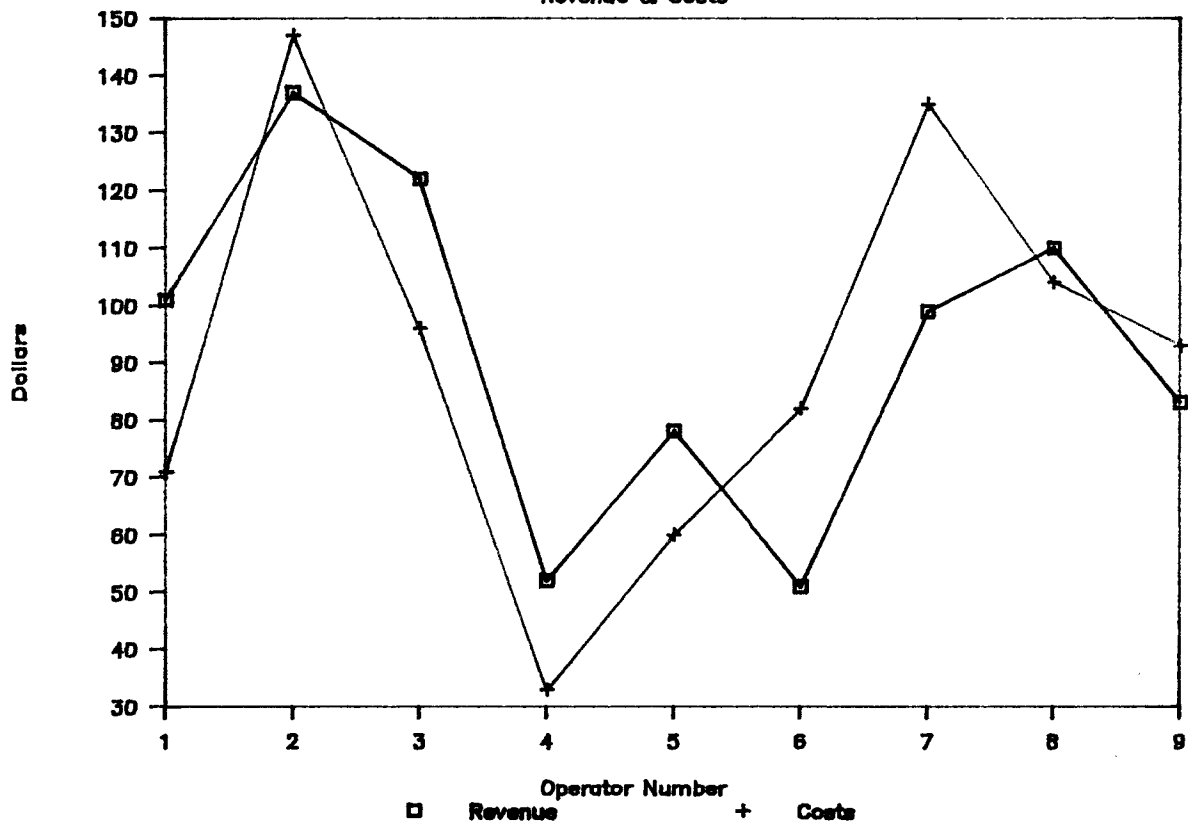
Abandoned Vehicles

Revenue & Costs



Emergency Tows

Revenue & Costs



It should be reemphasized at this point that the above figures are largely the result of franchisee representations regarding the income generated and costs incurred by various aspects of their business. Audit staff reliance on such representations was necessitated by time constraints and the fact that most franchisees do not maintain separate accounts for City generated tows.

An additional problem that makes comparisons such as those shown above tenuous is the profound fundamental differences between the franchisees. For example, one of the franchisees owns its land and building free and clear. This same franchisee uses equipment that is paid for and fully depreciated. Because of these factors, this franchisee's cost per tow is significantly lower than other franchises with mortgages on their business and new equipment that they are financing and depreciating.

An additional factor that cannot be quantified is the degree to which entrepreneurial skills and operational efficiencies impacted the above results. While this factor may be causal to the ultimate profitability of a franchise operation no attempt was made to assess its influence.

Accordingly, while the information displayed in Charts I through III is indicative of the condition of City generated towing operations, it is not absolute or conclusive.

Insurance Costs*

According to various franchisee representatives, rapidly escalating insurance costs are a justification for increasing the City established maximum tow charge of \$49.00. Our review of franchisee financial records indicates that in 1985 insurance costs ranged from \$15,695 to \$71,629 and accounted for 3.8 to 14.8 percent of total franchise operating expenses as shown below.

| <u>Operator Number</u> | <u>INSURANCE COSTS*</u> | |
|------------------------|-------------------------|--------------------------------------|
| | <u>Total</u> | <u>Percent of Total Expenses</u> |
| 1 | \$15,695 | 5.6% |
| 2 | 36,183 | 7.3 |
| 3 | 22,985 | 14.8 |
| 4 | 25,321 | 5.1 |
| 5 | ** | ** |
| 6 | 35,055 | 8.9 |
| 7 | 55,322 | 11.1 |
| 8 | 32,516 | 3.8 |
| 9 | 71,629 | 6.8 |

*Totals may include both liability and other insurance (workmen's compensation, etc) paid by the franchisees.

**Not available for a full 12 months.

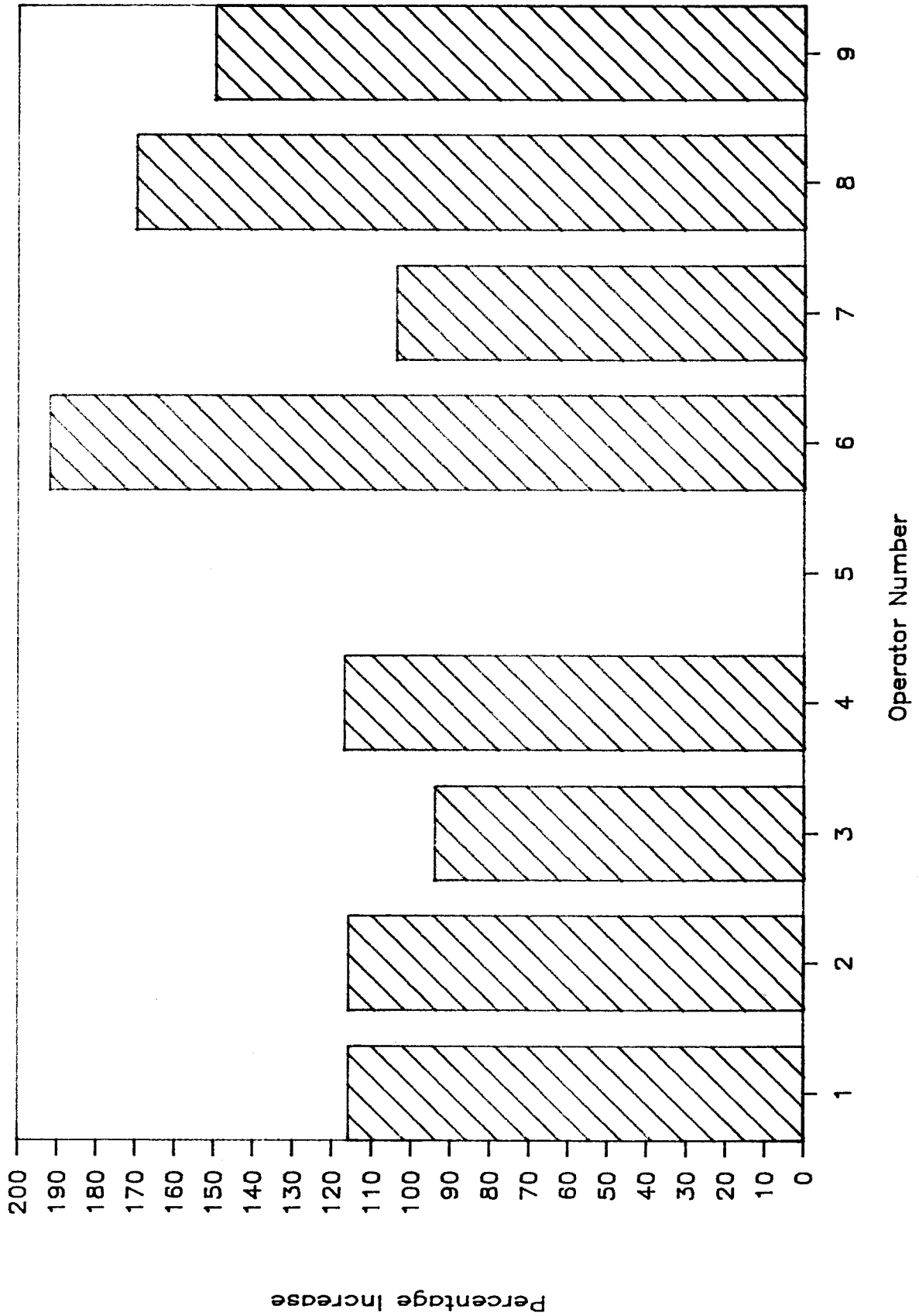
Discussions with franchise towing companies regarding 1986 insurance costs revealed a range of premium increases on liability insurance from 94 to 192 percent as shown in Chart IV.

Obviously franchise towing companies are experiencing much the same phenomenon regarding insurance costs as are many other segments of the United States economy. In these times of relatively stable prices, prodigious increases in insurance costs are an aberration.

Franchisees can make a case for a larger maximum tow charge than the Administration's proposed two percent by isolating insurance costs. However, before reaching a conclusion on the maximum tow rate issue other factors need to be considered. For example, another phenomenon in the United States today is declining oil and gasoline prices. This is extremely pertinent to the towing industry because of high oil and gasoline usage. Another factor is recent interest rate reductions. Of the nine franchisees, six are incurring interest expenses on loan repayments that vary from \$10,552 to \$50,752. Accordingly, when all factors are considered increased insurance costs are not sufficient in and of themselves to account for observed or anticipated franchisee losses on City generated tows.

CHART IV

Insurance Costs — Percentage Increases



Franchise Fees

An additional concern voiced by certain franchise towing companies is that the 13 percent Franchise Fee is onerous given the lack of profitability on City generated business. Our analysis revealed that based upon total City generated revenues for the nine franchise towing companies, Franchise Fees would have been \$145,824. As such, Franchise Fees would have comprised approximately 9 percent of total City generated towing expenses for the nine franchisees as shown below:

| <u>Operator Number</u> | <u>Calculated Franchise Fees*</u> | <u>Percent of Total City Generated Towing Expenses</u> |
|----------------------------|---------------------------------------|----------------------------------------------------------------|
| 1 | \$ 10,013 | 13.8% |
| 2 | 6,392 | 5.1 |
| 3 | 4,637 | 10.5 |
| 4 | 11,317 | 14.8 |
| 5 | 15,399 | 13.8 |
| 6 | 28,911 | 8.4 |
| 7 | 11,144 | 6.6 |
| 8 | 18,699 | 9.4 |
| 9 | <u>39,312</u> | <u>9.2</u> |
| TOTAL | <u>\$145,824</u> | <u>9.3%</u> |

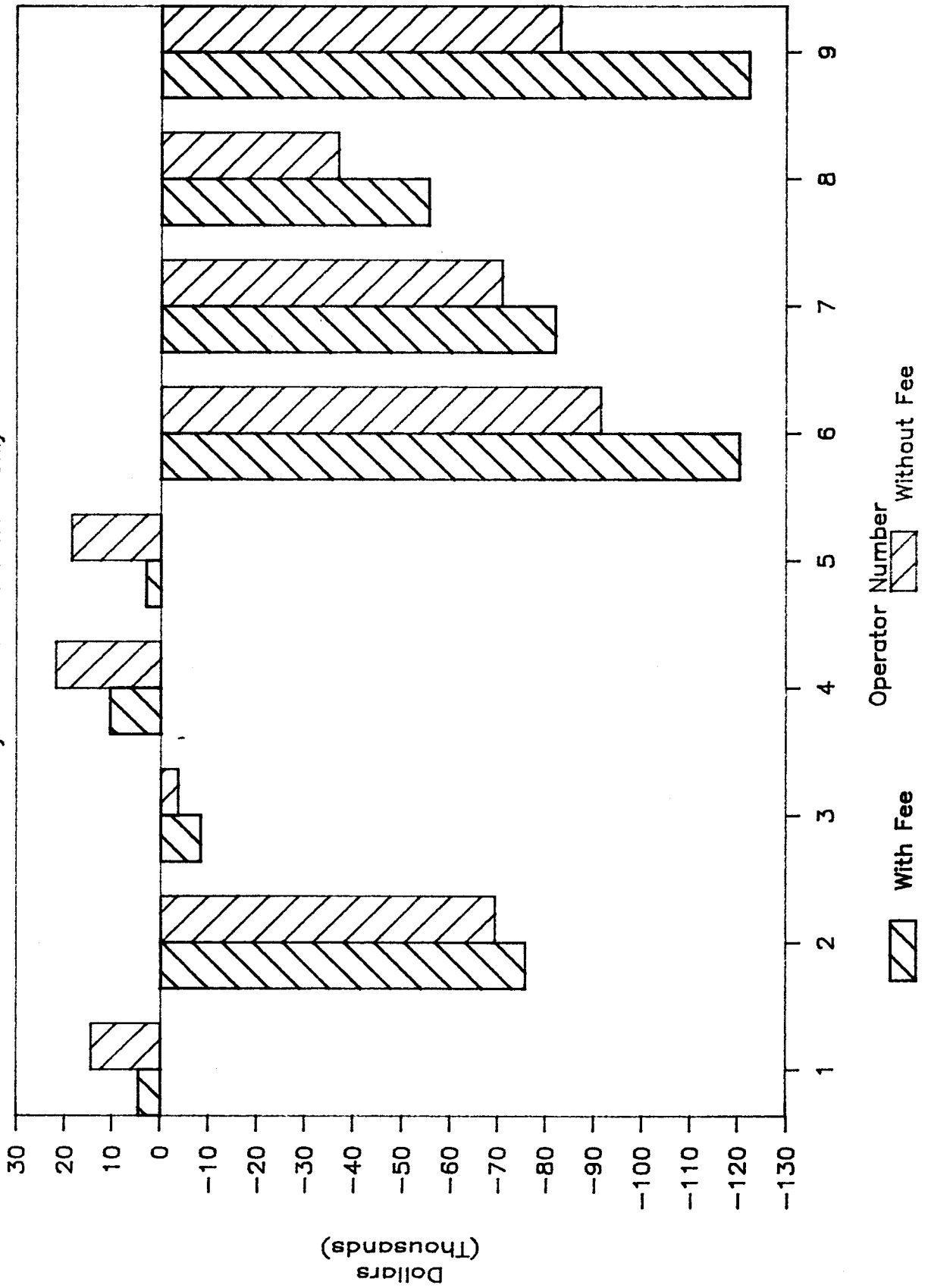
*Represents 13% of City generated towing revenues.

Further analysis revealed that in no instance did the imposition of the Franchise Fee mean the difference between making a profit and incurring a loss on City generated tows as is shown in Chart V.

CHART V

Franchise Fee Effect on Company Profits

City Generated Business Only



As Chart V illustrates the three franchisees making a profit on City generated tows (Operator Numbers 1, 4 and 5) would do so regardless of the imposition of the Franchise Fee.

However, it should be noted that the franchisees incurring the largest losses on City generated tows ironically are required to pay the largest Franchisee Fees as is shown below:

| <u>Operator Number</u> | <u>Loss on City Generated Tows</u> | <u>Franchise Fee</u> |
|----------------------------|----------------------------------------|----------------------|
| 6 | \$120,137 | \$28,911 |
| 9 | 89,210 | 39,312 |

Lack of Geographic Zone Comparability

A major problem regarding the issue of City towing is that the nine geographic zones are not homogeneous regarding the volume or type of City generated tows.

Chart VI is a graphic display of the number and type of City generated tows by franchise towing company.

As shown in Chart VI, there is a great deal of disparity between the franchise towing companies as to 1) the total number of City generated tows and 2) the relative mix of emergency and abandoned tows. This disparity makes comparisons between the franchisees obscure. However, it is significant that the franchisees identified as Operator Numbers 6 and 9:

- o Responded to twice as many City generated tows as any other franchisee
- o Towed more abandoned vehicles than the other seven franchisees combined and
- o Incurred the largest estimated losses on City tows (\$120,137 and \$89,210, respectively).

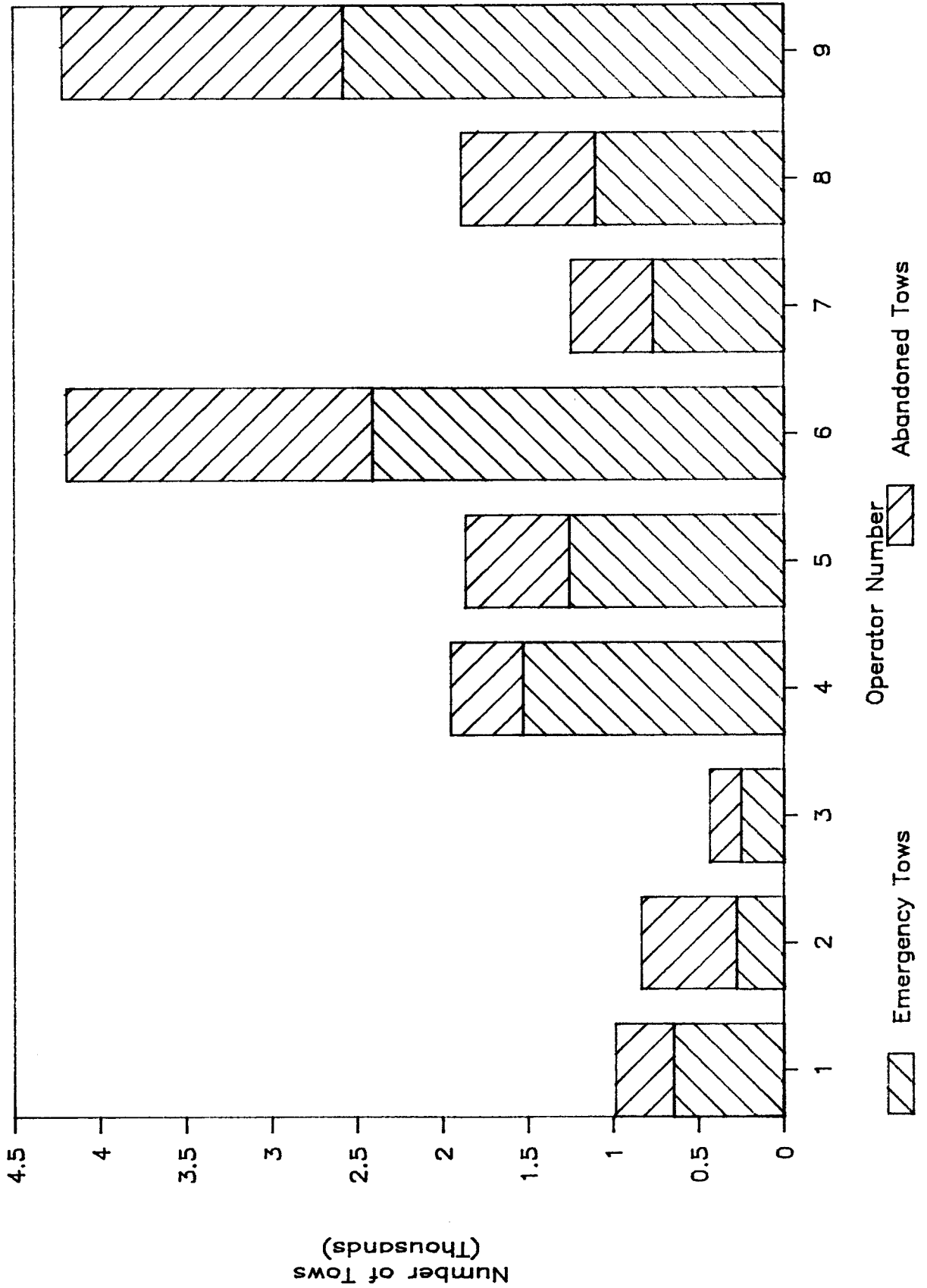
Based upon our analysis it is readily apparent that abandoned vehicles are a major source of franchise operating losses. We estimate that it costs a franchisee from \$33 to \$147 to handle an abandoned vehicle. Offsetting this cost is the revenue derived from the scrapping of the vehicles. We estimate this revenue to be between \$0 and \$30 per vehicle. Thus franchisees are estimated to incur a loss of \$15 to \$127 per abandoned vehicle.

Based upon our review it appears that some form of City assistance is in order. One means of assistance would be to temporarily eliminate the Franchise Fee imposed on franchise towing companies. This would cost the City approximately \$150,000* per year if relief was granted to all franchisees.

*Assuming all Franchise Fees were paid.

CHART VI

Composition of City Generated Tows



Another means of City assistance would be to address the abandoned vehicle problem by either developing a disposal site or providing a City subsidy to franchisees for each abandoned vehicle disposed. Should the City opt for reduced or eliminated Franchise Fees or an abandoned vehicle subsidy, it is imperative that the City impose sufficient recordkeeping requirements on franchisees to allow for subsequent City assessment of the need to continue providing assistance to the franchisees.

CONCLUSION

Franchise towing companies are in general incurring losses on City generated tows. While increased insurance costs have contributed to recent losses they are not sufficient in and of themselves to account for the current situation. Comparisons of franchisees are difficult to make because neither the franchisees nor their specific geographic towing zones are homogeneous. Abandoned vehicles do, however, seem to be the one problem common to all of the franchisees. Based upon our review some form of City relief or assistance is needed.

RECOMMENDATIONS

It is recommended that:

Recommendation #1:

The Administration consider recommending to the City Council that some temporary relief from Franchise Fees be granted to franchise towing companies.

Recommendation #2:

The Administration consider recommending to the City Council that the City temporarily pay a subsidy to franchise towing companies to partially offset the cost of handling abandoned vehicles.

Recommendations #3:

Should Recommendations 1 and 2 be adopted, the Administration should impose on franchise towing companies sufficiently stringent recordkeeping requirements to facilitate subsequent City assessment of the need to continue providing assistance to the franchisees.

EXHIBIT A
SUMMARY OF DATA
=====

| | #1 | | | #2 | | | #3 | | |
|---------------------------|------------------|---------------------|-------|------------------|---------------------|--------|---------------|-----------------------|-------|
| | Police Gener. | Abandon Vehicles | Other | Police Gener. | Abandon Vehicles | Other | Police Gen | Abandoned Vehicles | Other |
| TOWS | 988 | 342 | 646 | 838 | 559 | 279 | 435 | 185 | 250 |
| REVENUE PER TOW | \$78 | \$34 | \$101 | \$59 | \$20 | \$137 | \$82 | \$28 | \$122 |
| COST PER TOW | \$71 | \$71 | \$71 | \$147 | \$147 | \$147 | \$96 | \$96 | \$96 |
| NET INCOME (LOSS) PER TOW | \$7 | (\$37) | \$30 | (\$88) | (\$127) | (\$10) | (\$14) | (\$68) | \$26 |

INCOME AND EXPENSES

| | | | | | | | | | |
|----------------|----------|------------|----------|------------|------------|-----------|-----------|------------|----------|
| Income | \$77,021 | \$11,730 | \$65,291 | \$49,167 | \$11,000 | \$38,167 | \$35,668 | \$5,089 | \$30,579 |
| Total Expenses | \$70,464 | \$24,391 | \$46,073 | \$123,245 | \$82,212 | \$41,033 | \$41,693 | \$17,732 | \$23,961 |
| Net Income | \$6,557 | (\$12,661) | \$19,218 | (\$74,078) | (\$71,212) | (\$2,866) | (\$6,025) | (\$12,643) | \$6,618 |

EXHIBIT A (Cont'd)
SUMMARY OF DATA
=====

| | #4 | | | #5 | | | #6 | | |
|---------------------------|---------------|-----------------------|-------|---------------|-----------------------|-------|---------------|-----------------------|--------|
| | Police Gen | Abandoned Vehicles | Other | Police Gen | Abandoned Vehicles | Other | Police Gen | Abandoned Vehicles | Other |
| TOWS | 1955 | 422 | 1533 | 1865 | 604 | 1261 | 4200 | 1791 | 2409 |
| REVENUE PER TOW | \$45 | \$18 | \$52 | \$64 | \$34 | \$78 | \$53 | \$55 | \$51 |
| COST PER TOW | \$33 | \$33 | \$33 | \$60 | \$60 | \$60 | \$82 | \$82 | \$82 |
| NET INCOME (LOSS) PER TOW | \$11 | (\$15) | \$19 | \$4 | (\$26) | \$18 | (\$29) | (\$26) | (\$30) |

INCOME AND EXPENSES

| | | | | | | | | | |
|----------------|----------|-----------|----------|-----------|------------|----------|-------------|------------|------------|
| Income | \$87,051 | \$7,550 | \$79,501 | \$118,451 | \$20,588 | \$97,863 | \$222,390 | \$98,984 | \$123,406 |
| Total Expenses | \$65,206 | \$14,075 | \$51,131 | \$111,907 | \$36,242 | \$75,665 | \$342,527 | \$146,063 | \$196,464 |
| Net Income | \$21,845 | (\$6,525) | \$28,370 | \$6,544 | (\$15,654) | \$22,198 | (\$120,137) | (\$47,079) | (\$73,058) |

EXHIBIT A (Cont'd)
SUMMARY OF DATA
=====

| | #7 | | | #8 | | | #9 | | |
|---------------------------|---------------|-----------------------|--------|---------------|-----------------------|-------|---------------|-----------------------|--------|
| | Police Gen | Abandoned Vehicles | Other | Police Gen | Abandoned Vehicles | Other | Police Gen | Abandoned Vehicles | Other |
| TOWS | 1252 | 485 | 767 | 1889 | 785 | 1104 | 4220 | 1642 | 2578 |
| REVENUE PER TOW | \$68 | \$21 | \$99 | \$76 | \$29 | \$110 | \$72 | \$54 | \$83 |
| COST PER TOW | \$135 | \$135 | \$135 | \$104 | \$104 | \$104 | \$93 | \$93 | \$93 |
| NET INCOME (LOSS) PER TOW | (\$66) | (\$114) | (\$36) | (\$28) | (\$75) | \$6 | (\$21) | (\$39) | (\$10) |

INCOME AND EXPENSES

| | | | | | | | | | |
|----------------|------------|------------|------------|------------|------------|-----------|------------|------------|------------|
| Income | \$85,725 | \$10,000 | \$75,725 | \$143,835 | \$22,470 | \$121,365 | \$302,471 | \$88,684 | \$213,787 |
| Total Expenses | \$168,401 | \$65,235 | \$103,166 | \$196,504 | \$81,660 | \$114,844 | \$391,681 | \$152,403 | \$239,278 |
| Net Income | (\$82,676) | (\$55,235) | (\$27,441) | (\$52,669) | (\$59,190) | \$6,521 | (\$89,210) | (\$63,719) | (\$25,491) |